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UNITED STATES
POSTAL REGULATORY COMMISSION
Washington, D.C. 20268-0001

FORM 10-Q

(Mark One)

☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended December 31, 2016
or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from ________to________
Commission File Number: N/A

UNITED STATES POSTAL SERVICE

(Exact name of registrant as specified in its charter)

Washington, D.C.	41-0760000
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
475 L'Enfant Plaza, S.W.	
Washington, D.C.	20260
(Address of principal executive offices)	(ZIP Code)

(202) 268-2000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the *Securities Exchange Act of 1934* during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☐
Not Applicable ☑

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐ Not Applicable ☑

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐
Not Applicable ☑

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ☐ No ☑

The number of shares of common stock outstanding as of February 8, 2017: N/A

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

UNITED STATES POSTAL SERVICE
STATEMENTS OF OPERATIONS
(UNAUDITED)

(in millions)	Three Months Ended December 31, 2016	Three Months Ended December 31, 2015
Revenue		
Operating revenue	$ 19,192	$ 19,347
Other revenue	9	12
Total revenue	**19,201**	**19,359**
Operating expenses		
Compensation and benefits	13,389	12,735
Retiree health benefits	969	2,242
Workers' compensation	(1,123)	(196)
Transportation	2,026	1,880
Other operating expenses	2,455	2,341
Total operating expenses	**17,716**	**19,002**
Income from operations	**1,485**	**357**
Interest and investment income	9	6
Interest expense	(56)	(56)
Net income	**$ 1,438**	**$ 307**

UNITED STATES POSTAL SERVICE
BALANCE SHEETS

(in millions)	December 31, 2016	September 30, 2016
	(Unaudited)	
Current Assets:		
Cash and cash equivalents	$ 8,196	$ 8,077
Restricted cash	336	253
Receivables, net	1,146	1,042
Supplies, advances and prepayments	195	140
Total current assets	**9,873**	**9,512**
Property and equipment, net	15,284	15,296
Other assets	421	411
Total assets	**$ 25,578**	**$ 25,219**
Current Liabilities:		
Compensation and benefits	$ 2,943	$ 2,669
Retiree health benefits	34,869	33,900
Workers' compensation costs	1,474	1,427
Payables and accrued expenses	1,954	1,892
Deferred revenue-prepaid postage	2,228	2,253
Customer deposit accounts	1,266	1,246
Other current liabilities	1,149	1,128
Current portion of debt	10,100	10,100
Total current liabilities	**55,983**	**54,615**
Workers' compensation costs, noncurrent	16,110	18,612
Employees' accumulated leave, noncurrent	1,986	1,926
Other noncurrent liabilities	1,143	1,148
Noncurrent portion of debt	4,900	4,900
Total liabilities	**80,122**	**81,201**
Net Deficiency:		
Capital contributions of the U.S. Government	3,132	3,132
Deficit since 1971 reorganization	(57,676)	(59,114)
Total net deficiency	**(54,544)**	**(55,982)**
Total liabilities and net deficiency	**$ 25,578**	**$ 25,219**

See accompanying notes to the unaudited financial statements.

UNITED STATES POSTAL SERVICE
STATEMENTS OF CASH FLOWS
(UNAUDITED)

(in millions)	Three Months Ended December 31, 2016	2015
Cash flows from operating activities:		
Net income	$ 1,438	$ 307
Adjustments to reconcile net income to cash provided by operations:		
Depreciation and amortization	408	427
(Gain) loss on disposals of property and equipment, net	(2)	15
Increase in other assets	(10)	(5)
Decrease in noncurrent workers' compensation	(2,502)	(1,639)
Decrease in noncurrent deferred appropriations and other revenue	(90)	(13)
Increase in other noncurrent liabilities	157	17
Changes in current assets and liabilities:		
Receivables, net	(104)	(36)
Other current assets	(55)	(68)
Retiree health benefits	969	1,451
Payables, accrued expenses and other	496	446
Deferred revenue-prepaid postage, prepaid box rents and other	(38)	11
Net cash provided by operating activities	**667**	**913**
Cash flows from investing activities:		
Change in restricted cash	(83)	4
Purchases of property and equipment	(442)	(275)
Proceeds from sales of property and equipment	(3)	48
Net cash used in investing activities	**(528)**	**(223)**
Cash flows from financing activities:		
Issuance of notes payable	2,700	2,700
Payments on notes payable	(2,700)	(2,700)
Payments on capital lease obligations and other	(20)	(18)
Net cash used in financing activities	**(20)**	**(18)**
Net increase in cash and cash equivalents	119	672
Cash and cash equivalents at beginning of period	8,077	6,634
Cash and cash equivalents at end of period	**$ 8,196**	**$ 7,306**
Supplemental cash flow disclosures:		
Cash paid for interest	$ 56	$ 52

See accompanying notes to the unaudited financial statements.

NOTES TO UNAUDITED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

Interim Financial Statements

The accompanying unaudited interim financial statements of the United States Postal Service (the "Postal Service") have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of the U.S. Securities and Exchange Commission ("SEC") Regulation S-X. These financial statements should be read in conjunction with the Postal Service's financial statements for the year ended September 30, 2016, included in its Annual Report on Form 10-K ("Annual Report") filed with the Postal Regulatory Commission ("PRC") on November 15, 2016, and do not include all information and footnotes which are normally included in the Annual Report. Except as otherwise specified, all references to years are to the fiscal year beginning October 1 and ending September 30, and quarters are quarters within fiscal years 2017 and 2016.

In the opinion of management, the accompanying unaudited interim financial statements reflect all material adjustments, including recurring adjustments, necessary to fairly present the financial position as of December 31, 2016, and the results of operations and cash flows for the three months ended December 31, 2016, and 2015. Operating results for the three months ended December 31, 2016, are not necessarily indicative of the results that may be expected for all of 2017. Mail volume and revenue are historically greatest in the first quarter of the fiscal year, which includes the holiday mailing season.

Recent Accounting Standards

Accounting Standards Update 2014-09 Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2014-09 *Revenue from Contracts with Customers* ("ASU 2014-09"). The new standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. As originally issued, ASU 2014-09 would become effective for the Postal Service's 2018 fiscal year, with early adoption not permitted.

In July 2015, the FASB voted for a one-year deferral of the effective date of the standard, thereby becoming effective for the Postal Service's 2019 fiscal year and the quarters therein, with an option that would permit reporting entities to adopt the standard as early as the original effective date. The new standard may be adopted either retrospectively or on a modified retrospective basis whereby the new standard would be applied to new and existing contracts with remaining performance obligations as of the effective date, with a cumulative catch-up adjustment recorded to beginning retained earnings or net deficiency at the effective date for existing contracts with remaining performance obligations. The Postal Service is currently evaluating the impact of adopting this standard retrospectively on its financial statements, which is not known or reasonably estimable at this time.

Accounting Standards Update 2014-15 Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern

In August 2014, the FASB issued Accounting Standards Update 2014-15 *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* ("ASU 2014-15"). The new standard requires an entity to perform interim and annual assessments of its ability to continue to meet obligations as they become due within one year after the date that the financial statements are issued. ASU 2014-15 is effective for the Postal Service's 2017 fiscal year and the quarters thereafter. The Postal Service does not believe the adoption of the new standard will have a significant impact on its reported disclosures.

Accounting Standards Update 2016-02 Leases

In February 2016, the FASB issued Accounting Standards Update 2016-02 *Leases* ("ASU 2016-02"). The new standard requires an entity to record most leases on its balance sheets but continue to recognize expenses in the statements of operations in a manner similar to current accounting practices. The new standard states that a lessee will recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. Expenses related to leases determined to be operating leases will be recognized on a straight-line basis, while those determined to be capital leases will generally have higher expense in the earlier periods of the lease and both interest and amortization are presented separately in the statements of operations.

ASU 2016-02 will become effective for the Postal Service's 2020 fiscal year and the quarters therein, with early adoption permitted. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Postal Service is currently evaluating the impact of adopting this standard on its financial statements and disclosures, but given the significant number of leases in place, the Postal Service expects that the adoption will have a material effect on its financial statements and disclosures.

Accounting Standards Update 2016-04 Liabilities - Extinguishments of Liabilities

In March 2016, the FASB issued Accounting Standards Update 2016-04 *Liabilities - Extinguishments of Liabilities* ("ASU 2016-04"). The new standard requires entities that sell prepaid stored-value products redeemable for goods, services or cash at third-party merchants to recognize "breakage" (i.e., the value that is ultimately not redeemed by the consumer) in a way that is consistent with how gift card breakage will be recognized under ASU 2014-09, discussed earlier.

ASU 2016-04 will become effective for the Postal Service's 2019 fiscal year and the quarters therein, with early adoption permitted. The new standard may be adopted either retrospectively or on a modified retrospective basis with a cumulative catch-up adjustment recorded to beginning retained earnings or net deficiency as of the beginning of the fiscal year the standard is effective. The standard is applicable to the Postal Service's determination of money orders and related escheatment. The Postal Service is currently evaluating the impact of adopting this standard on its financial statements and disclosures.

Accounting Standards Update 2016-18 Statement of Cash Flows, Restricted Cash

In November 2016, the FASB issued Accounting Standards Update 2016-18 *Statement of Cash Flows, Restricted Cash* ("ASU 2016-18"). The new standard provides final guidance, based on a consensus of the Emerging Issues Task Force, to clarify how entities should present restricted cash in the statements of cash flows. The new standard requires entities to show the change in the total of cash, cash equivalents and restricted cash and no longer present transfers between cash and cash equivalents and restricted cash in the statements of cash flows.

ASU 2016-18 will become effective for the Postal Service's 2019 fiscal year and the quarters therein, with early adoption permitted. The Postal Service is currently evaluating the impact of adopting this standard on its financial statements and disclosures.

NOTE 2 - LIQUIDITY

The Postal Service generates its cash almost entirely through the sale of postal products and services. It holds its cash with the Federal Reserve Bank of New York and invests its excess cash, when available, in highly-liquid, short-term investments issued by the U.S. Department of the Treasury. As of December 31, 2016, and September 30, 2016, the Postal Service held unrestricted cash and cash equivalents of $8.2 billion and $8.1 billion, respectively.

Debt

The Federal Financing Bank ("FFB"), a government-owned corporation under the general supervision of the Secretary of the Treasury, holds all of the Postal Service's debt, which consists of two revolving credit facilities and fixed and floating-rate notes with various maturities. As of both December 31, 2016, and September 30, 2016, the aggregate principal balance of debt outstanding was $15.0 billion, the maximum borrowing amount allowed under the Postal Service's statutory debt ceiling. The Postal Service has reported $15.0 billion in outstanding debt each quarter since September 30, 2012.

The two revolving credit facilities referenced above have interest rates determined by the U.S. Department of the Treasury each business day and enable the Postal Service to draw up to $4.0 billion in total. As of December 31, 2016, and September 30, 2016, these facilities were fully drawn and were included in the current portion of debt. These annually-renewable facilities were renewed and extended through April 2017.

Liquidity Concerns

The Postal Service is constrained by laws and regulations, including the *Postal Accountability and Enhancement Act*, Public Law 109-435 ("PAEA"), which restricts revenue sources and mandates certain expenses. From October 1, 2006, to September 30, 2016, these expenses included prefunding requirements for retiree health benefits unlike those imposed on most other federal entities or private sector businesses. The PAEA established the Postal Service Retiree Health Benefits Fund ("PSRHBF") and mandated certain obligations for paying the normal costs and prefunding of retiree health benefits, described below and in *Note 7 - Health Benefits Plans*. Additionally, as noted above, the Postal Service has reached the maximum borrowing capacity under its statutory debt ceiling.

Available liquidity (cash and short-term investments, plus available borrowing capacity) has increased by approximately $6 billion from the reported 2012 low. This improvement would not have occurred had the Postal Service not defaulted on the annual PSRHBF prefunding payments in years 2012 through 2016, discussed in greater detail in *Note 7 - Health Benefits Plans*. In addition to these defaults, the improvement in liquidity is also attributable to the temporary exigent surcharge (discussed in greater detail below) which generated approximately $4.6 billion in incremental revenue from January 2014 through April 10, 2016, as well as the Postal Service's management of operating expenses under its control and deferral of certain non-essential capital expenditures.

Notwithstanding this increase in liquidity, the Postal Service has incurred cumulative net losses of $60.9 billion from 2007 through December 31, 2016, has defaulted on $33.9 billion in PSRHBF prefunding payments, and had annual operating expenses of approximately $77 billion in 2016. Notwithstanding the Postal Service's net income for the three months ended December 31, 2016, it projects continuing annual net losses in the future absent legislative and regulatory change. As a result of these losses and its liquidity concerns, the Postal Service does not have sufficient liquidity to meet all of its existing legal obligations when due, pay down its debt and make the critical infrastructure investments that have been deferred in recent years.

Expiration of Exigent Surcharge

The PRC authorized the Postal Service to collect an exigent surcharge on Market-Dominant services beginning in January 2014 until the surcharge produced just over $4.6 billion in incremental revenue, a figure the PRC determined was lost due to the Great Recession's suppression of mail volume. As required by the PRC, the Postal Service reduced the prices of applicable Market-Dominant services on April 10, 2016, the date the incremental revenue limit was reached.

The absence of the exigent surcharge, which produced incremental revenue of approximately $570 million for the three months ended December 31, 2015, negatively affected revenue for the three months ended December 31, 2016.

Business Model Challenges/Constraints

Market-Dominant services, which account for approximately 74% of the Postal Service's annual operating revenues, are subject to a price cap as measured by the Consumer Price Index for All Urban Consumers ("CPI-U"). However, the Postal Service's costs are not similarly limited. A large portion of its cost structure cannot be altered expeditiously due to the Postal Service's universal service obligation, and the number of delivery points continues to grow by approximately one million per year, which drives up delivery costs. Accordingly, the Postal Service is generally unable to increase prices sufficiently to offset increased costs.

Aside from the universal service obligation, a significant factor contributing to Postal Service losses is the ongoing decline in the volume of *First-Class Mail*, which generates a higher contribution than other mail classes. This decline is largely the result of changes in consumers' and businesses' use of mail (reduced advertising budgets and fewer credit and financial accounts), which were exacerbated by the Great Recession. To a lesser extent, *First-Class Mail* volume has been negatively affected by the continuing migration to electronic communication and transactional alternatives. Also contributing to losses is the increase in the number of delivery points, which, when combined with the impact of the reduction in mail volume, has resulted in a drop in the average number of pieces delivered per delivery point per day from 5.5 pieces in 2007 to 3.7 pieces in 2016, a decline of approximately 32%.

Because the Postal Service provides its services primarily through its employees, its costs are heavily concentrated in wages and employee and retiree benefits. These costs are significantly impacted by wage inflation, health benefit premium increases, and retirement and workers' compensation programs. Some of these costs have historically tended to increase at a higher rate than inflation as measured by the CPI-U.

Changes Required by Statute in 2017

In 2017, the Postal Service's funding requirements for retiree health benefits changed. In accordance with PAEA, the PSRHBF is to be used to fund the Postal Service's share of retiree health benefit premiums, and the U.S. Office of Personnel Management ("OPM") will determine the amount of annual payments the Postal Service will need to make to amortize the PSRHBF unfunded liability no later than June 30, 2017.

Based on OPM's preliminary valuation of the PSRHBF funded status as of September 30, 2016, the Postal Service calculated that the unfunded liability is approximately $18.2 billion and the Postal Service estimates that the related amortization payments for the unfunded liability will be $907 million annually. However, the OPM is not legally required to provide an amortization schedule or corresponding bill for the unfunded plan balance until June 30, 2017. As such, these preliminary estimates are subject to change.

Furthermore, the Postal Service also remains obligated to fund the $33.9 billion in PSRHBF prefunding payments that it had defaulted on for the years 2012 through 2016, which is reflected as a current liability within *Retiree health benefits* in the accompanying balance sheets. OPM may establish a payment schedule by June 30, 2017, under which the Postal Service would be obligated to pay down this liability, including a progress payment due in 2017.

The Postal Service is also obligated to pay the normal costs of retiree health benefits attributable to the service of Postal Service employees during the most recently ended fiscal year, which OPM currently estimates is approximately $2.9 billion in 2017.

Also in 2017, obligations pertaining to the Civil Service Retirement System ("CSRS") changed according to the PAEA, and OPM will now determine the amount of annual payments the Postal Service must make to fully amortize its CSRS unfunded liabilities. OPM estimates that this payment obligation will be approximately $1.2 billion annually, which may be required as soon as September 2017. This matter is currently under review by the Office of Legal Counsel at the U.S. Department of Justice, to confirm whether these payments should begin in 2017 or 2018.

The following table shows a composition of the expenses related to retiree health benefits and CSRS for the three months ended December 31, 2015, and the estimated expense recognized for the three months ended December 31, 2016, which gives effect to changes in retiree health benefits and CSRS that are taking effect in 2017:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Amortization of PSRHBF prefunding liability[1]	$ 227	$ —
PSRHBF prefunding fixed amount[2]	—	1,450
Normal cost of retiree health benefits[3]	742	—
Retiree health benefits premiums[4]	—	792
CSRS supplemental unfunded liability expense[5]	308	—

[1] Accrual for one quarter of the estimated $907 million annual payment, as determined by the Postal Service based on OPM's preliminary estimate of the remaining $18.2 billion PSRHBF unfunded liability as calculated based on OPM's preliminary valuation of the PSRHBF funded status as of September 30, 2016.

[2] Accrual for one quarter of the $5.8 billion annual prefunding payment to be paid into the PSRHBF due September 30, 2016.

[3] Accrual for one quarter of the estimated $2.9 billion annual payment based on OPM's estimate of actuarially-determined normal cost of retiree health benefits for current employees to be paid into the PSRHBF.

[4] Expense for one quarter of the amount the Postal Service was billed for its share of retiree health benefit premiums for annuitants by OPM. Beginning in 2017, the PSRHBF is to be used to fund the Postal Service's share of retiree health benefit premiums.

[5] Accrual for one quarter of OPM's estimated payment amount, based on actuarial valuations and assumptions, to amortize the $16.7 billion unfunded CSRS retirement obligation as of September 30, 2015. Payments are to be made in equal installments beginning as soon as 2017, through 2043.

The Postal Service anticipates that given its ongoing liquidity concerns, and without legislative action, it may not be able to make all legally-required payments in 2017. Additionally, the Postal Service believes that continuing productivity improvements alone will not be sufficient to address the challenges presented by declining Market-Dominant volume and revenue, and that revenue enhancements will unlikely be able to keep pace with increased costs.

Mitigating Circumstances

The Postal Service's status as an independent establishment of the executive branch that does not receive tax dollars for its operations presents unique requirements and restrictions, but also potentially mitigates some of the financial risk that would otherwise be associated with a cash shortfall. With annual total revenue of approximately $71 billion, a financially-sound Postal Service continues to be vital to U.S. commerce.

The U.S. economy benefits greatly from the Postal Service and the many businesses that provide the printing and mailing services that it supports. Disruption of the mail would cause undue hardship to businesses and consumers, and in the event of a cash shortfall, the U.S. government would likely prevent the Postal Service from significantly curtailing or ceasing operations. The Postal Service continues to inform the Administration, Congress, the PRC and other stakeholders of the immediate and long-term financial challenges it faces and the legislative changes that are required to restore its financial stability.

NOTE 3 - RELATED PARTIES

As disclosed throughout this report, the Postal Service has significant transactions with other U.S. government entities, which are considered related parties for accounting purposes.

The following table presents related-party assets and liabilities as of December 31, 2016, and September 30, 2016:

(in millions)	December 31, 2016		September 30, 2016	
Related-party assets:				
Receivables and advances[1]	$	71	$	40
Carrying amount of revenue forgone installment receivable[2]		410		405
Related-party liabilities:				
Current portion of debt	$	10,100	$	10,100
Other current liabilities[3]		37,397		36,509
Noncurrent portion of debt		4,900		4,900
Other noncurrent liabilities[4]		16,135		18,638

[1] Included within *Receivables, net* in the accompanying Balance Sheets.
[2] Included within *Other assets* in the accompanying Balance Sheets.
[3] Amounts include PSRHBF and CSRS obligations and current workers' compensation obligations.
[4] Amounts include noncurrent workers' compensation obligations.

The following table presents related-party revenue and expenses for the three months ended December 31, 2016, and 2015:

(in millions)	Three Months Ended December 31,			
	2016		2015	
Related-party operating revenue[1]	$	229	$	321
Related-party operating expenses[2]	$	3,693	$	4,485
Related-party interest income[3]	$	9	$	6
Related-party interest expenses[4]	$	50	$	47

[1] Included within *Operating revenue* in the accompanying unaudited Statements of Operations.
[2] Included within *Operating expenses* in the accompanying unaudited Statements of Operations.
[3] Imputed on the revenue forgone installment receivable or generated on cash equivalents held with the Federal Reserve Bank of New York or short-term investments in U.S. Treasury instruments. Included within *Interest and investment income* in the accompanying unaudited Statements of Operations.
[4] Incurred on debt issued to the FFB, and included within *Interest expense* in the accompanying unaudited Statements of Operations.

NOTE 4 - PROPERTY AND EQUIPMENT, NET

Assets within *Property and equipment, net* in the accompanying Balance Sheets are recorded at cost, which includes the interest on borrowings used to finance construction of major capital additions, less allowances for depreciation and amortization. Interest capitalized during both the three months ended December 31, 2016, and 2015 was not significant. Fixed assets are depreciated over estimated useful lives ranging from 3 to 40 years using the straight-line method.

The book values of assets classified as held for sale were approximately $49 million and $43 million as of December 31, 2016, and September 30, 2016, respectively, and are included within *Property and equipment, net* in the accompanying Balance Sheets.

For the three months ended December 31, 2016, and 2015, depreciation and amortization expense was $408 million and $427 million, respectively, and impairment charges were de minimis. These items are included within *Other operating expenses* in the accompanying unaudited Statements of Operations.

NOTE 5 - COMMITMENTS AND CONTINGENCIES

Commitments

In December 2016, the Postal Service reached a tentative agreement on a new 40-month collective bargaining agreement with the National Postal Mail Handlers Union ("NPMHU") covering approximately 45,000 employees represented by the union. The tentative agreement is subject to a ratification vote by the NPMHU membership. Assuming it is ratified, the contract will run through September 20, 2019.

Contingencies

The Postal Service's contingent liabilities consist primarily of claims resulting from labor, employment, environmental matters, property damage and injuries on Postal Service properties, and issues arising from Postal Service contracts, personal claims and traffic accidents. Each quarter, the Postal Service evaluates each new claim to determine if it is probable of an unfavorable outcome and if the amount of the potential resolution is reasonably estimable. If so, a liability for the amount is recorded. Preexisting claims are also reviewed and adjusted quarterly for resolutions or revisions to prior estimates.

The Postal Service has made adequate provision for probable losses arising from all claims. The following table presents contingent liabilities by current and noncurrent portions and by category, as of December 31, 2016, and September 30, 2016:

(in millions)	December 31, 2016	September 30, 2016
Current/noncurrent portions of contingent liabilities:		
Current portion[1]	$ 197	$ 166
Noncurrent portion[2]	526	498
Total contingent liabilities	**$ 723**	**$ 664**
Contingent liabilities by category:		
Labor and employment matters	$ 613	$ 565
Asset retirement obligations	54	47
Tort matters	52	48
Contractual matters	4	4
Total contingent liabilities	**$ 723**	**$ 664**

[1] Included within *Payables and accrued expenses* in the accompanying Balance Sheets.
[2] Included within *Other noncurrent liabilities* in the accompanying Balance Sheets.

In addition to accruals for probable losses in the financial statements, the Postal Service also has claims which it deems reasonably possible of an unfavorable outcome, which are not accrued for in the financial statements. These ranged in amount from $225 million to $950 million at December 31, 2016, and from $225 million to $950 million at September 30, 2016. The Postal Service is from time to time involved in other litigation incidental to the conduct of its business, none of which is expected to be material to its financial condition or operations.

NOTE 6 - RETIREMENT PLANS

The majority of employees participate in one of two U.S. government pension programs, the CSRS and the Federal Employee Retirement System ("FERS"), which are administered by OPM. Each employee's participation in either plan is largely based on the starting date of employment with the Postal Service or other U.S. government entity.

As government-sponsored benefit plans, the CSRS and FERS are not subject to the provisions of the *Employee Retirement Income Security Act of 1974*, as amended. Likewise, because the Postal Service cannot direct the costs, benefits or funding requirements of these plans, it accounts for program expenses under multiemployer plan accounting rules. As such, the Postal Service records contributions to the plans as an expense in the period in which each contribution is due.

PAEA suspended the Postal Service's CSRS contributions that would otherwise have been required under Title 5, Section 8334(a)(1) of the U.S. Code until 2017, at which time OPM will determine if additional funding is required for the benefit of Postal Service's CSRS retirees. OPM estimates that this payment obligation will be approximately $1.2 billion annually, which may be required as soon as September 2017. This matter is currently under review by the Office of Legal Counsel at the U.S.

Department of Justice, to confirm whether these payments should begin in 2017 or 2018. As a result, the Postal Service has accrued $308 million for the three months ended December 31, 2016.

For FERS employees, OPM has set the Postal Service's contribution rates at 13.7% of base salary for both 2017 and 2016. FERS employees may also participate in the Thrift Savings Plan ("TSP"), a defined contribution retirement savings and investment plan administered by the Federal Retirement Thrift Investment Board, whereby the Postal Service contributes 1% of basic pay and matches voluntary employee contributions up to an additional 4% of basic pay.

Retirement expenses were $2.0 billion and $1.7 billion for the three months ended December 31, 2016, and 2015, respectively. Retirement expenses are included within *Compensation and benefits* in the accompanying unaudited Statements of Operations.

NOTE 7 - HEALTH BENEFITS PLANS

The Federal Employees Health Benefits ("FEHB") Program covers nearly all career employees and also covers non-career employees and retirees who meet certain eligibility requirements. OPM administers FEHB and allocates the cost of funding the program to participating U.S. government employers. The Postal Service cannot direct the costs, benefits or funding requirements of the plans, and therefore accounts for program expenses using multiemployer plan accounting rules by recording contributions to the plans as an expense in the period in which the contributions are due. Although OPM determines the actual health benefits premium costs, the allocation of these costs between the Postal Service and most of its employees is determined through agreements with Postal Service labor unions. Separate from FEHB, the Postal Service offers its own healthcare plan to certain non-career employees who are ineligible for FEHB.

Active Employees

The Postal Service paid approximately 74% and 75% of FEHB premium costs during the three months ended December 31, 2016, and 2015, respectively. Postal Service employee healthcare expense was $1.3 billion and $1.2 billion during the three months ended December 31, 2016, and 2015, respectively. These expenses are included within *Compensation and benefits* in the accompanying unaudited Statements of Operations.

Retirees

Retirees who participated in the FEHB for the five years immediately preceding their retirement may continue to participate in the program during retirement. Eligible participants include former employees (or their qualifying survivors, if applicable) who retired on or after July 1, 1971, based on each retiree's length of federal civilian service occurring after that date. Each participant's share of premium costs is set by law and is not subject to negotiation with Postal Service labor unions. Prior to 2017, the Postal Service expensed what it was billed by OPM for its share of retiree health premiums.

For the years 2007 through 2016, the PAEA required that the Postal Service prefund retiree health benefits by paying fixed amounts into the PSRHBF, which was to be used to pay the Postal Service's share of retiree health benefit premiums beginning in 2017. The Postal Service defaulted on $33.9 billion of the PSRHBF prefunding payments for the years 2012 through 2016. Given that OPM considers this defaulted amount to be due and payable, the Postal Service continues to reflect the amount as a current liability within *Retiree health benefits* in the accompanying balance sheets. OPM may establish a payment schedule by June 30, 2017, under which the Postal Service would be obligated to pay down this liability, including a progress payment due in 2017.

The PAEA requires that OPM perform an actuarial valuation no later than June 30, 2017, for the funding of any remaining unfunded PSRHBF liability over a period of 40 years through 2056. Based on OPM's preliminary valuation of the PSRHBF funded status as of September 30, 2016, the Postal Service calculated that the unfunded liability is approximately $18.2 billion, and the Postal Service estimates that the related amortization payments for the unfunded liability will be $907 million annually. Based on the annual estimate, the Postal Service has accrued a $227 million expense, included within *Retiree health benefits* in the accompanying unaudited Statement of Operations, for the three months ended December 31, 2016.

Since OPM is not legally required to provide an amortization schedule or corresponding bill for the unfunded plan balance until June 30, 2017, these preliminary estimates, which currently represent the best data available, are subject to change. Upon receipt of such amortization schedule and bill from OPM, the Postal Service will revise its accrual for the unfunded liability as necessary.

The Postal Service is also obligated to pay the normal costs of retiree health benefits attributable to the service of Postal Service employees during the most recently ended fiscal year, which OPM currently estimates is approximately $2.9 billion in 2017. Based on the annual estimate, the Postal Service accrued a $742 million expense, included within *Compensation and benefits* in the accompanying unaudited Statements of Operations, for the three months ended December 31, 2016.

The following table details retiree health benefits expenses, including the changes that are taking effect in fiscal year 2017 in accordance with the PAEA, for the three months ended December 31, 2016, and 2015:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Amortization of PSRHBF unfunded liability[1]	$ 227	$ —
PSRHBF prefunding fixed amount[2]	—	1,450
Normal cost of retiree health benefits[3]	742	—
Retiree health benefits premiums[4]	—	792
Total retiree health benefits expense	**$ 969**	**$ 2,242**

[1] Accrual for one quarter of the estimated $907 million annual payment, as determined by the Postal Service based on OPM's preliminary estimate of the remaining $18.2 billion PSRHBF unfunded liability as calculated based on OPM's preliminary valuation of the PSRHBF funded status as of September 30, 2016.

[2] Accrual for one quarter of the $5.8 billion annual prefunding payment to be paid into the PSRHBF due September 30, 2016.

[3] Accrual for one quarter of the estimated $2.9 billion annual payment based on OPM's estimate of actuarially-determined normal cost of retiree health benefits for current employees to be paid into the PSRHBF.

[4] Expense for one quarter of the amount the Postal Service was billed for its share of retiree health benefit premiums for annuitants by OPM. Beginning in 2017, the PSRHBF is to be used to fund the Postal Service's share of retiree health benefit premiums.

NOTE 8 - WORKERS' COMPENSATION

Postal Service employees injured on the job are covered by the Federal Employees' Compensation Act ("FECA"), administered by the Department of Labor's ("DOL") Office of Workers' Compensation Programs, which makes all decisions regarding injured workers' eligibility for benefits. The Postal Service reimburses the DOL for all workers' compensation benefits paid to or on behalf of Postal Service employees, plus an administrative fee.

Workers' Compensation Liability

The Postal Service records a liability for its workers' compensation obligations for employees who have been injured on the job and are eligible for benefits, or their qualified survivors. This liability is recorded as both a current and non-current liability in the accompanying Balance Sheets.

To determine the fair value of the liability each quarter, the Postal Service first estimates the future total cost of workers' compensation claims based on the dates of claim-related injuries, frequency or severity of the injuries, the pattern of historical payments to beneficiaries and the expected trend in future costs. The Postal Service uses an estimation model that combines four generally-accepted actuarial valuation techniques based upon past claim-payment experience and exposure to claims as measured by total employee hours worked. Changes in the actuarial valuation are primarily attributable to the combined impacts of routine changes in actuarial assumptions, new compensation and medical cases, the progression of existing cases and changes in inflation rates, including long-term cost-of-living adjustment rates for compensation claims, and medical rates for medical claims.

The Postal Service then calculates the amount that would need to be invested at current discount (interest) rates to fully fund the future total cost of claims, and this calculated present value is the fair value of workers' compensation liability. This liability calculation is highly sensitive to changes in discount rates. For example, a 1% increase in the discount rate would decrease the December 31, 2016, liability and related expense by approximately $1.9 billion. Likewise, a 1% decrease in the discount rate would increase the December 31, 2016, liability and related expense by approximately $2.3 billion.

The following table details the applicable inflation and discount rates as of December 31, 2016, and September 30, 2016:

	December 31, 2016	September 30, 2016
Compensation claims liability:		
Discount rate	2.7%	1.9%
Wage inflation	2.6%	2.6%
Medical claims liability:		
Discount rate	2.7%	1.9%
Medical inflation	5.5%	5.5%

Workers' Compensation Expense

The impacts of changes in discount rates and inflation rates, as well as the actuarial valuation of new cases and revaluation of existing cases, are components of total workers' compensation expense as recorded in the accompanying unaudited Statements of Operations. The Postal Service also pays an administrative fee to the DOL, which is also a component of workers' compensation expense.

The following table presents the components of workers' compensation expense (benefit) for the three months ended December 31, 2016, and 2015:

(in millions)	Three Months Ended December 31, 2016	2015
Impact of discount rate changes	$ (1,670)	$ (402)
Actuarial revaluation of existing cases	52	(222)
Cost of new cases	402	410
Administrative fee	93	18
Total workers' compensation expense (benefit)	**$ (1,123)**	**$ (196)**

NOTE 9 - FAIR VALUE MEASUREMENT

The Postal Service defines fair value as the price that would be received upon sale of an asset or the price that would be paid to transfer a liability between unrelated parties.

The carrying amounts of certain current assets and liabilities, including cash, accounts receivable, accounts payable, accrued expenses and the current portion of debt, approximate fair value due to their short-term nature. Assets within *Property and equipment, net* are recorded at cost and measured at fair value on a nonrecurring basis if they are determined to be impaired or classified as assets held for sale.

Noncurrent receivables and noncurrent debt are measured using a fair value hierarchy model. This model prioritizes observable and unobservable inputs used to measure fair value, and consists of three broad levels, as defined in authoritative literature.

For the periods ended December 31, 2016, and September 30, 2016, no significant transfers between *Level 1* and *Level 2* assets or liabilities transpired. The carrying amount and fair value of the revenue forgone installment receivable and the noncurrent portion of debt are presented for disclosure purposes only in the following table:

(in millions)	December 31, 2016		September 30, 2016	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Revenue forgone installment receivable*	$ 410	$ 486	$ 405	$ 527
Noncurrent portion of debt	$ 4,900	$ 5,223	$ 4,900	$ 5,492

* The carrying amount is included within *Other assets* (which includes items in addition to revenue forgone) in the accompanying Balance Sheets.

The revenue forgone installment receivable qualifies as a financial instrument in accordance with authoritative literature. To calculate its fair value, the Postal Service recognizes the imputed interest it is owed as interest income and estimates the value of this receivable using the interest method, which converts future cash flows to a single discounted amount using interest rates for similar assets, which are considered *Level 2* inputs. The Postal Service then calculates the net present value of anticipated annual installment payments to be received, discounted by the 20-year Treasury Constant Maturity Rate, which was 2.79% and 1.99% as of December 31, 2016, and September 30, 2016, respectively.

The noncurrent portion of debt also qualifies as a financial instrument. Because no active market exists for the Postal Service's debt with the FFB, the fair value of the noncurrent portion of this liability has been estimated using expected future payments at risk-adjusted discount rates provided by the FFB, considered *Level 3* inputs.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENTS

The following *Management's Discussion and Analysis of Financial Condition and Results of Operations* and other parts of this report describe the principal factors affecting the financial results, liquidity, capital resources and critical accounting estimates of the United States Postal Service ("Postal Service," "USPS," "we," "our" and "us"). Our results of operations may be impacted by risks and uncertainties discussed here and in our Annual Report on Form 10-K for the year ended September 30, 2016 ("Annual Report") filed with the Postal Regulatory Commission ("PRC") on November 15, 2016. Such factors, many of which we cannot control or influence, may cause actual results to differ materially from those currently contemplated.

Unless otherwise noted, our operating results for the three months ended December 31, 2016, are presented in accordance with accounting principles generally accepted in the United States ("GAAP"). These results are not necessarily indicative of the results to be expected for the year ended September 30, 2017, and should be read in conjunction with our Annual Report. All references to years in this report, unless otherwise stated, refer to fiscal years beginning October 1 and ending September 30. All references to quarters, unless otherwise stated, refer to quarters within fiscal years 2017 and 2016.

Forward-looking statements contained in this report represent our best estimates of known and anticipated trends believed relevant to future operations. However, actual results may differ significantly from current estimates. Certain forward-looking statements included in this report use such words as "may," "will," "could," "expect," "believe," "plan," "estimate," "project" or other similar terminology. These forward-looking statements, which involve a number of risks and uncertainties, reflect current expectations regarding future events and operating performance as of the date of this report. We have no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

OVERVIEW

With our mandate to provide universal postal services to the nation, we serve retail and commercial customers in the United States, as well as internationally. Our operations include an extensive and integrated retail, distribution, transportation and delivery network.

The *Postal Accountability and Enhancement Act* ("PAEA") classifies our products into two broad categories: Market-Dominant and Competitive "products," however, we use the term "services" in this document for consistency with other descriptions of services offered. The PAEA also established certain requirements that affect our financial results, most notably the mandate that we prefund retiree health benefits through the Postal Service Retiree Health Benefits Fund ("PSRHBF"), and we must coordinate with the U.S. Office of Personnel Management ("OPM") to address these and other obligations.

We have successfully implemented initiatives that have reduced our costs by billions of dollars while offering broader services. However, legal restrictions on pricing, service diversification and operations restrict our ability to fully implement our strategic objectives and cover our costs to provide secure, reliable and affordable postal services to the nation.

We have established a core set of goals that drive our strategic initiatives and continuous improvement efforts:

1. Deliver a world-class customer experience,
2. Equip, empower and engage employees,
3. Innovate faster to deliver value, and
4. Invest in our future platforms.

As part of these efforts, we aim to achieve long-term financial stability, as well as a reduction in our debt. Our focus on maintaining liquidity and reducing operating expenses reflects current trends, as well as projected future volume of mail and packages. We believe that consistent revenue growth is within reach as we continue to identify and create innovative and affordable services, and deliver high levels of performance and capabilities.

RESULTS OF OPERATIONS

SUMMARY

The major factors that impact our operating results include overall customer demand, the mix of postal services and contribution associated with those services, volume of mail and packages processed through our network and our ability to manage our cost structure in line with declining mail volume, growth in more labor-intensive Shipping and Packages volume and an increasing number of delivery points. We operate as a single segment and report our performance as such.

Three Months Ended December 31, 2016

Operating revenue for the three months ended December 31, 2016, decreased $155 million, or 0.8%, compared to the same period last year. Revenue from combined *First-Class Mail* and *Standard Mail* (which was renamed *USPS Marketing Mail*, or more commonly, *Marketing Mail*, effective January 22, 2017) declined by $792 million for the period. This decline was largely attributable to the April 2016 expiration of the exigent surcharge, which generated approximately $570 million in incremental revenue during the same period last year. These declines were nearly offset by the increase in Shipping and Packages revenue of $701 million, or 14.7%, as we continued to see growth in this business throughout the quarter.

Operating expenses for the three months ended December 31, 2016, decreased $1.3 billion, or 6.8%, compared to the same period last year. This was largely the result of a decrease in our retiree health benefits expense of $1.3 billion due to the change in funding requirements for retiree health benefits taking effect in 2017 (discussed in greater detail below in *Operating Expenses*, *Retiree Health Benefits*). Also contributing to the reduction in operating expenses was a favorable change in workers' compensation expense of $927 million, compared to the same period last year, resulting primarily from higher discount rates which reduced our workers' compensation liability.

The reductions in operating expenses were offset partially by increased compensation and benefits expense of $654 million, driven largely by higher retirement benefits expenses and also from a 2.7% increase in the amount of labor hours used to support higher Shipping and Packages volumes. Transportation costs also increased $146 million, compared to the same period last year, due to the increase in Shipping and Packages volumes, which require greater transportation capacity than mail, and because of transportation costs that were incurred in an effort to improve service levels.

These changes in revenue and expenses resulted in a net income of $1.4 billion for the three months ended December 31, 2016, compared to a net income of $307 million for the same period last year, an increase of $1.1 billion.

Non-GAAP Controllable Income

In the day-to-day operation of our business, we focus on costs within our control, such as salaries and transportation. We calculate controllable income, a non-GAAP measure, by excluding items we cannot control, such as workers' compensation expenses caused by actuarial revaluation and discount rate changes, PSRHBF prefunding expenses and the amortization of PSRHBF, CSRS and FERS unfunded obligations. Controllable income should not be considered a substitute for net income and other GAAP reporting measures.

The following table reconciles our GAAP net income to controllable income for the three months ended December 31, 2016 and 2015:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Net income	**$ 1,438**	**$ 307**
Amortization of PSRHBF prefunding liability[1]	227	—
PSRHBF prefunding fixed amount[2]	—	1,450
CSRS supplemental unfunded liability expense[3]	308	—
FERS supplemental unfunded liability expense[4]	62	60
Change in workers' compensation liability related to fluctuations in discount rates	(1,670)	(402)
Other change in workers' compensation liability[5]	157	(158)
Controllable income	**$ 522**	**$ 1,257**

[1] Accrual for one quarter of the estimated $907 million annual payment, as determined by the Postal Service based on OPM's preliminary estimate of the remaining $18.2 billion PSRHBF unfunded liability as calculated based on OPM's preliminary valuation of the PSRHBF funded status as of September 30, 2016.

[2] Accrual for one quarter of the $5.8 billion annual prefunding payment to be paid into the PSRHBF due September 30, 2016.

[3] Accrual for OPM's estimated payment amount, based on actuarial valuations and assumptions, to amortize the $16.7 billion unfunded CSRS retirement obligation as of September 30, 2015. Payments are to be made in equal installments beginning as soon as 2017, through 2043.

[4] Amounts represent one quarter of the accrual for the payment amount, based on actuarial valuations and assumptions, to amortize the $3.8 billion unfunded FERS retirement obligation as of September 30, 2015, as determined by OPM. Payments are to be made in equal installments through 2046.

[5] Net amounts include changes in assumptions, as well as the valuation of new claims and revaluation of existing claims, less current year claim payments.

For the three months ended December 31, 2016, controllable income decreased $735 million from the same period last year. This decrease was driven by an increase in controllable compensation expense of $247 million, the decline in operating revenue of $155 million and an increase in transportation expense of $146 million. These items are discussed in greater detail in *Operating Revenue and Volume* and *Operating Expenses*.

OPERATING REVENUE AND VOLUME

First-Class Mail and *Marketing Mail* continued to provide the majority of our revenue for the three months ended December 31, 2016, despite long-term trends away from hard copy communication to electronic media. *First-Class Mail* generated 36% of our revenue and 38% of our volume, while *Marketing Mail* generated 24% of revenue and 54% of volume. This represents a 3% decrease in the percentage of our revenue and a 1% decrease in the percentage of our volume generated by *First-Class Mail*, compared to the same period last year. The percentage of our revenue and volume generated by *Marketing Mail* was essentially unchanged compared to the same period last year.

For the three months ended December 31, 2016, our operating revenue was $19.2 billion, a decrease of $155 million, or 0.8%, compared to the same period last year. This decrease was driven primarily by decreases in *First-Class Mail* and *Marketing Mail* revenue due to the expiration of the exigent surcharge, largely offset by increases in Shipping and Packages revenue, which grew by 14.7% on volume growth of 11.0%, compared to the same period last year.

While we continue to experience strong results in our Shipping and Packages business, it represented only 28% of our revenues for the three months ended December 31, 2016, compared to *First-Class Mail*, which represented 36%. Furthermore, Shipping and Packages generated only 4% of our volume for the three months ended December 31, 2016. Based on our 2016 metrics, we need to generate approximately $2 in Shipping and Packages revenue to replace the contribution from each $1 of lost *First-Class Mail* revenue, as the costs associated with Shipping and Packages services were, and continue to be, substantially higher than the costs associated with *First-Class Mail*.

Although revenue and volume are closely linked to the strength of the U.S. economy and changes in how our customers use the mail, we have been active in addressing growth opportunities. We continue to concentrate on our customers' needs and have increased our marketing investment, as well as focusing on mail and package innovation. However, we also recognize that revenue growth is constrained by laws and regulations restricting the types of products, services and prices we can offer to our customers and the speed with which we can bring them to market.

To address the long-term trend that technological change and the lingering effects of the Great Recession have had on our *First-Class Mail* revenue and volume, we have focused on providing new services, growing e-commerce and implementing marketing campaigns that have helped us grow our Shipping and Packages business. By offering day-specific delivery, improved tracking and text alerts and up to $50 of free insurance on most *Priority Mail* packages, we have demonstrated our responsiveness to our customers.

The following table summarizes our operating revenue and volume for the three months ended December 31, 2016 and 2015, by each service line:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Operating Revenue:		
First-Class Mail[1]	$ 6,988	$ 7,556
Standard Mail (Marketing Mail)[2]	4,693	4,917
Shipping and Packages[3]	5,456	4,755
International	766	792
Periodicals	361	409
Other[4]	928	918
Total operating revenue	**$ 19,192**	**$ 19,347**
Volume:		
First-Class Mail[1]	15,880	16,426
Standard Mail (Marketing Mail)[2]	22,355	22,075
Shipping and Packages[3]	1,608	1,448
International	285	298
Periodicals	1,370	1,466
Other[5]	104	191
Total volume	**41,602**	**41,904**

[1] Excludes *First-Class Mail Parcels*.

[2] Excludes *Standard Mail Parcels* (*USPS Marketing Mail Parcels*).

[3] Includes *Priority Mail*, *USPS Retail Ground*, *Parcel Select Mail*, *Parcel Return Service Mail*, *Standard Mail Parcels* (*USPS Marketing Mail Parcels*), *Package Service Mail*, *First-Class Mail Parcels*, *First-Class Package Service* and *Priority Mail Express*.

[4] Revenue includes *PO Box services*, *Certified Mail*, Return Receipts, Insurance, Other Ancillary Services, Shipping and Mailing Supplies, Collect on Delivery, Registered Mail, Stamped Envelopes and Cards, money orders and Other services.

[5] Volume includes Postal Service internal mail and free mail provided to certain groups.

We implemented price increases on certain Market-Dominant services in May 2015 and January 2017. We also implemented price increases on certain Competitive services in January 2016 and January 2017.

The PRC authorized us to collect an exigent surcharge on Market-Dominant services beginning in January 2014 until the surcharge produced just over $4.6 billion in incremental revenue, a figure the PRC determined was lost due to the Great Recession's suppression of mail volume. We estimated that the limit on the incremental revenue from the surcharge was reached on April 10, 2016, and we therefore reduced the prices of most Market-Dominant services on that date, pursuant to an order of the PRC. Based on the amount of incremental revenue we received from the surcharge last year, we estimate that our revenue and cash flow for the three months ended December 31, 2016, was approximately $570 million lower than it would have been had the surcharge remained in place.

On December 20, 2016, the PRC commenced the ten-year review of its system for regulating rates and classes for Market-Dominant products as required by the PAEA. The objective of the review is to determine if the PAEA is achieving the objectives established by Congress. As part of this review, the PRC will evaluate the annual limitation on the percentage we can increase our prices, the schedule for price increases and other aspects of how we price our products and generate revenue. The outcome of this review may affect our future pricing methodology.

First-Class Mail

First-Class Mail, our most profitable service category, includes cards, letters, flats and parcels that weigh up to 13 ounces. *First-Class Mail* prices are the same regardless of how far the mail travels. For the three months ended December 31, 2016, *First-Class Mail* revenue decreased $568 million, or 7.5%, and volume decreased 3.3%, compared to the same period last year. Notwithstanding the continued migration from mail toward electronic communication and electronic transaction alternatives, we estimate that approximately $322 million of the revenue decline in *First-Class Mail* during the three months ended December 31, 2016, was attributable to the exigent surcharge expiration.

Marketing Mail

Marketing Mail is mail not required to be mailed as *First-Class Mail* or *Periodicals*, and may include advertising, newsletters, catalogs, small marketing parcels and other printed matter. For the three months ended December 31, 2016*, Marketing Mail* revenue decreased by $224 million, or 4.6%, despite volume growth of 1.3%, compared to the same period last year. We estimate that approximately $202 million of the revenue decline in *Marketing Mail* during the three months ended December 31, 2016, was attributable to the exigent surcharge expiration. Due to the 2016 general election, *Marketing Mail* benefited from political and election mail, which produced approximately $226 million in revenue on volume of 1.3 billion pieces during the quarter, compared to $42 million in revenue on volume of 214 million pieces for the same period last year. *Marketing Mail* revenue was also negatively impacted by the mail mix between commercial and nonprofit mailers.

Marketing Mail volume is reflective of the cyclical nature of the U.S. economy, although targeted advertising campaigns can stimulate demand for these services. Price increases for *Marketing Mail* are generally capped at the rate of inflation because they are classified by law as Market-Dominant.

Shipping and Packages

The following table summarizes our operating revenue and volume for Shipping and Packages for the three months ended December 31, 2016 and 2015, by each service:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Shipping and Packages Revenue:		
Priority Mail Services[1]	$ 2,711	$ 2,528
Parcel Services[2]	1,671	1,309
First-Class Packages[3]	858	691
Package Services	216	227
Total Shipping and Packages revenue	**$ 5,456**	**$ 4,755**
Shipping and Packages Volume:		
Priority Mail Services[1]	303	308
Parcel Services[2]	823	696
First-Class Packages[3]	304	270
Package Services	178	174
Total Shipping and Packages volume	**1,608**	**1,448**

[1] Includes *Priority Mail*, a 1-3 business day delivery service; *Priority Mail Express*, an overnight delivery service available 365 days per year; and *USPS Retail Ground,* a retail-only Market-Dominant service priced identically and functionally equivalent to *Priority Mail* for Zones 1-4.

[2] Includes *Parcel Select*, *Parcel Return*, *Standard Mail Parcels* (*USPS Marketing Mail Parcels*).

[3] Includes *First-Class Mail* Parcels and *First-Class Package Services*.

Our Shipping and Packages business has continued to show solid revenue and volume growth as a result of our successful efforts to compete in the ground shipping services and "last mile" e-commerce fulfillment markets, including Sunday delivery. Volume also experienced end-to-end growth as consumers continued to utilize online shopping, which provided a surge in package volume with a record number of packages delivered during the calendar year 2016 holiday season. To accommodate this surge in volume and avoid service disruptions during the holiday season, we increased Sunday delivery service for some of our customers in limited U.S. markets and added non-career employees for the season in accordance with our labor agreements.

Priority Mail Services

Priority Mail Services, our Shipping and Packages subcategory for retail and commercial customers, includes *Priority Mail*, *Priority Mail Express* and *Retail Ground*, and allows customers the ability to send documents and packages requiring expedited transportation and handling. While Priority Mail Services revenue continues to grow year-over-year, it is somewhat price sensitive, particularly with retail customers, and its growth rate is lower than some other Shipping and Packages subcategories used by commercial customers. Priority Mail Services accounts for our largest portion of Shipping and Packages revenue, representing approximately 49.7% of the total for the three months ended December 31, 2016, compared to 53.2% for the three months ended December 31, 2015.

For the three months ended December 31, 2016, Priority Mail Services revenue grew by 7.2%, although volume declined by 1.6%, compared to the same period last year. The divergence in revenue and volume was a result of the January 2016 Competitive service price increases and a slight decline in *Priority Mail Express* over-night deliveries.

Parcel Services

Our Parcel Services category includes *Parcel Select*, *Parcel Return* and *Standard Mail Parcels* (renamed *USPS Marketing Mail Parcels*), which are Competitive services largely consisting of "last-mile" deliveries, offered to bulk shippers or price-sensitive customers. For the three months ended December 31, 2016, revenue from Parcel Services increased by 27.7% compared to the same period last year. This category showed strong volume growth of 18.2% for the period, driven largely by the continuing growth of e-commerce. However, this category is one of our lowest priced services, and as a result, does not provide as much contribution when compared to many of our other services.

First-Class Packages

First-Class Packages includes *First-Class Package Service*, an under-one-pound Competitive service targeted to commercial customers, and *First-Class Mail Parcels*, a Market-Dominant under-13-ounce retail package product. This category offers commercial customers that ship primarily lightweight fulfillment parcels the lowest-priced expedited end-to-end package option in the marketplace.

For the three months ended December 31, 2016, First-Class Packages revenue increased 24.2% and volume grew by 12.6% compared to the same period last year. Revenue grew more than volume for the quarter due to the January 2016 price increase in Competitive services.

Package Services

Customers use our Package Services category for shipping merchandise or bound printed matter, including library and media mail, weighing up to 70 pounds. For the three months ended December 31, 2016, Package Services revenue decreased 4.8%, while volume increased by 2.3% compared to the same period last year.

This category has been affected by certain large mailers' increased use of drop shipments offset by lower price per piece on bound printed matter. This divergence affected the three months ended December 31, 2016, to a greater degree given higher volumes associated with the calendar year 2016 holiday season.

International Mail

Our International Mail category includes several services that enable customers, both domestic and abroad, to send international mail, including postcards, envelopes, flats, and packages with either standard or express delivery options. The majority of International Mail revenue is generated from "outbound services" that allow customers in the U.S. to send mail and packages to other countries.

For the three months ended December 31, 2016, International Mail revenue decreased 3.3%, and volume decreased by 4.4%, compared to the same period last year. We continue to experience an increase in lower-priced inbound mail volume, much of that from tracked letter packets and parcels related to international e-commerce. However, this increase in inbound volume was not enough to offset the declines in higher-priced outbound volume for three months ended December 31, 2016.

Periodicals

Our *Periodicals* class of mail is designed for newspapers, magazines and other periodical publications whose primary purpose is transmitting information to an established list of subscribers or requesters. For the three months ended December 31, 2016, *Periodicals* revenue decreased 11.7% and volume decreased by 6.5% compared to the same period last year. Trends in hard-copy reading behavior and shifts of advertising away from print have depressed this segment for years. *Periodicals* is not expected to rebound as electronic content continues to grow in popularity with the public.

Other

Other services include ancillary services such as *Certified Mail*, *PO Box* services, and *Return Receipt* services. Also included in this category are money orders and passport services. For the three months ended December 31, 2016, Other revenue increased by 1.1%, while volume decreased by 45.5%, compared to the same period last year. This category includes our internal mail, which generated no revenue and has volume that can vary significantly from period to period.

OPERATING EXPENSES

In an effort to align our resources with anticipated future mail and package volume, we continue to aggressively manage operating expenditures under management's control.

Our mail processing and distribution network was originally designed to provide overnight delivery service of *First-Class Mail* within specified delivery areas to a much higher volume of mail than we are required to process and deliver today, and the network's legacy capabilities are excessive relative to today's mail volume. Consequently, many of our processing and distribution facilities continue to operate at less than full capacity. Our challenge to contain costs is also compounded by the continuing increase in the number of delivery points, which, when combined with the impact of lower hard copy mail volume, has resulted in a drop in the average number of pieces delivered per delivery point per day from approximately 5.5 pieces in 2007 to 3.7 pieces in 2016, a reduction of approximately 32%.

Compensation and Benefits

Compensation and benefits expenses consist of costs related to our active career and non-career employees. The following table presents compensation and benefits expenses for the three months ended December 31, 2016 and 2015:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Compensation	$ 9,986	$ 9,739
Retirement	2,043	1,706
Employee health benefits	1,273	1,203
Other	87	87
Total compensation and benefits	**$ 13,389**	**$ 12,735**

Compensation

Compensation expense increased 2.5% for the three months ended December 31, 2016, compared to the same period last year. The increase was primarily due to an increase in total work hours and an increased number of employees. For the three months ended December 31, 2016, total work hours were 309 million, an increase of approximately 8 million work hours, or 2.7%, from the 301 million total work hours for the three months ended December 31, 2015.

The number of career employees increased by approximately 10,000 as of December 31, 2016, compared to the same date last year, primarily reflecting the conversion of non-career employees to career status, resulting from the increased work hours necessary to process and deliver growing package volume to an increased number of delivery points. Although these recently-converted career employees are compensated at higher rates than non-career employees, these conversions to career status are at the lower tier career employee rate, in accordance with the provisions of our labor agreements. The additional use of these lower wage employees (both non-career and employees newly converted from non-career to career) has provided an offset to upward wage pressures from salary increases and rising benefit costs.

In December 2016, we reached a tentative agreement on a new 40-month collective bargaining agreement with the National Postal Mail Handlers Union ("NPMHU") covering approximately 45,000 employees represented by the union. The tentative agreement is subject to a ratification vote by the NPMHU membership. Assuming it is ratified, the contract will run through September 20, 2019.

Retirement
The majority of career employees participate in one of two U.S. government pension programs based on the starting date of their employment with a U.S. government employer. All expenses of the retirement programs, except for retiree health benefits, are included in compensation and benefits expense. Our FERS contribution rate remained steady at 13.7% of basic pay for most participants during both fiscal 2017 and 2016. Due to PAEA, we are now accruing for our estimated annual CSRS contribution of $1.2 billion for 2017, after having no contribution for 2016. For additional information, see *Item 1. Financial Statements, Notes to Unaudited Financial Statements, Note 6 - Retirement Plans*.

Retirement expense increased 19.8% for the three months ended December 31, 2016, compared to the same period last year. The most significant factors contributing to this increase were the $308 million accrual for our CSRS contribution, and to a lesser extent, the increase in the number of career employees.

Employee Health Benefits
Employee health benefits expense increased 5.8% for the three months ended December 31, 2016, compared to the same period last year, due to a sharp increase in premiums for the 2016 calendar year. On average, healthcare premiums rose 8.0% for the 2016 plan year, which affected the three months ended December 31, 2016, although this increase was partially offset by the lower contribution rate of healthcare premiums that we paid, and the shift of certain employees from "Family Coverage" to a "Self Plus One" option under the Federal Employees Health Benefits ("FEHB") Program.

Our share of healthcare premiums for our employees represented 74.2% and 74.9% of the total healthcare premium cost for the three months ended December 31, 2016, and 2015, respectively, consistent with our contractual agreements, but the effects of the quarterly decrease were offset by a higher number of employees receiving health benefits and higher premium costs.

Retiree Health Benefits
We participate in federal employee benefit programs for retiree health benefits. Under PAEA, we are obligated to fully fund the employer's portion of the established health and retirement benefits of retirees and our current employees (as discussed in *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*, *Note 7 - Health Benefits Plans*).

For the three months ended December 31, 2016, retiree health benefits expense declined by $1.3 billion compared to the same period last year. This was primarily due to changes in how we fund retiree health benefits that are to take effect in 2017 according to law.

In accordance with PAEA, beginning in 2017, the PSRHBF is to be used to fund our share of retiree health benefit premiums. We are also obligated to begin paying the normal costs of retiree health benefits attributable to the service of our employees during the most recently ended fiscal year, which OPM estimates is approximately $2.9 billion in 2017. Because the amounts scheduled to be paid into the PSRHBF are set by legislation, our retiree health benefits expense may represent more than the full normal cost of the benefits earned by our employees.

Additionally, OPM will determine the amount of annual payments we will need to make to amortize the PSRHBF unfunded liability. OPM's preliminary estimate of the unfunded liability is $18.2 billion; based on that amount we estimate that the amortization payments for the unfunded liability will be $907 million annually, and we have accrued $227 million in the first quarter for this payment.

Since OPM is not legally required to provide an amortization schedule or corresponding bill for the unfunded plan balance until June 30, 2017, these preliminary estimates, which currently represent the best data available, are subject to change. Upon receipt of such amortization schedule and bill from the OPM, we will revise our accrual for the unfunded liability as necessary.

Furthermore, we remain obligated to fund the $33.9 billion in PSRHBF prefunding payments that we defaulted on for the years 2012 through 2016. OPM may establish a payment schedule by June 30, 2017, under which we would be obligated to pay down this liability, including a progress payment due in 2017.

Workers' Compensation
Our employees injured on the job are covered by the Federal Employees' Compensation Act ("FECA"), administered by the Department of Labor's ("DOL") Office of Workers' Compensation Programs, which makes all decisions regarding injured workers' eligibility for benefits. Our workers' compensation expense reflects the impacts of changes in discount and inflation rates, as well as the actuarial valuation of new workers' compensation cases and revaluation of existing ones. We reimburse the DOL for all workers' compensation benefits paid to or on behalf of our employees, plus an administrative fee.

Workers' Compensation Expense
For the three months ended December 31, 2016, the portion of workers' compensation expense due to the impact of discount rate changes was a $1.7 billion benefit, compared to a $402 million benefit for the same period last year, an increase in benefit of $1.3 billion. These changes are the result of economic activity, namely increases in interest rates, outside of management's control.

The costs of new cases increased workers' compensation expense by $402 million for the three months ended December 31, 2016, compared to an increase of $410 million for the same period last year, resulting in a net decrease of $8 million.

The actuarial revaluation of existing cases increased workers' compensation expense by $52 million for the three months ended December 31, 2016, compared to a decrease of $222 million for the same period last year, resulting in a net increase of $274 million.

Changes in actuarial valuation are primarily attributable to the combined impacts of routine changes in actuarial estimation, new compensation and medical cases, the progression of existing cases and updated cost-of-living adjustment assumptions, which are largely outside of management's control. Payments made by the DOL on behalf of workers' compensation obligations were $316 million for the three months ended December 31, 2016, compared to $364 million for the same period last year.

Under FECA, workers' compensation claims for many types of injuries cannot be settled through lump-sum payments, and in some instances with regard to those claims, compensation may be paid over many years. Federal law grants cost-of-living adjustments to those claims, and these factors result in substantially higher costs to us than would likely result if we managed our own claims. Additionally, since we do not manage the FECA program, we have no ability to control the significant administrative costs associated with managing the claims and payments process.

Transportation
Transportation expense includes only the costs we incur to transport mail and other products between our facilities, not our costs of transportation to delivery points, which costs are included in *Other operating expenses.* Transportation expenses are primarily comprised of contracted highway, air and international transportation costs. Variations in the volume and weight of mail being transported and the mode of transportation used have significant impact on transportation expenses. The components of transportation expense for the three months ended December 31, 2016 and 2015 were as follows:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Highway	$ 1,157	$ 1,066
Air	660	597
International	183	201
Other	26	16
Total transportation expenses*	**$ 2,026**	**$ 1,880**

* Transportation expense includes only the costs we incur to transport mail and other products between our facilities and does not include actual delivery costs to final destination points.

Overall transportation expense increased 7.8% for the three months ended December 31, 2016, compared to the same period last year. During the three months ended December 31, 2016, highway and air transportation expenses increased 8.5% and 10.6%, respectively, compared to the same period last year, due in large part to package volume growth and our strategic efforts to continue to improve our delivery service results, as we have increased both our highway miles and the volume of our air transportation. The increases in these categories were also impacted by an increase in average diesel fuel prices, affecting our highway network, and an increase in average jet fuel prices, affecting our air network. International transportation expenses, which represent expenses related only to outbound services, decreased 9.0% primarily due to a decline in *Priority Mail International* and other international service volumes.

Other Operating Expenses

The following table details other operating expenses for the three months ended December 31, 2016 and 2015:

	Three Months Ended December 31,	
(in millions)	**2016**	**2015**
Supplies and services	$ 770	$ 674
Depreciation and amortization	408	427
Rent and utilities	397	393
Vehicle maintenance service	164	159
Fuel - delivery vehicles	96	95
Information technology and communications	196	173
Rural carrier equipment maintenance	129	130
Miscellaneous other	295	290
Total other operating expenses	**$ 2,455**	**$ 2,341**

LIQUIDITY AND CAPITAL RESOURCES

We held unrestricted cash and cash equivalents of $8.2 billion and $8.1 billion as of December 31, 2016, and September 30, 2016, respectively. Our average daily liquidity balance during the three months ended December 31, 2016, was $8.2 billion, representing approximately 30 days of liquidity available, which we define as unrestricted cash plus available borrowing capacity divided by estimated average cash disbursements (including capital expenditures) per business day (usually 251 cash disbursement days per year).

CASH FLOW ANALYSIS

Although our cash balances have increased since 2012, they remain insufficient to support an organization with approximately $77 billion in annual operating expenses. More significantly, this increase would not have occurred at all had we not been forced to default on $33.9 billion in legally-obligated PSRHBF prefunding payments. Looking forward, our operations will require significant capital investment over the next few years to modernize and improve our processing and delivery infrastructure in order to be able to continue to meet our statutory obligation to provide prompt, efficient and reliable postal services to the nation. Furthermore, given our inability to raise cash through the issuance of additional debt, our current level of available liquidity may be insufficient to support our operations in the event of another significant downturn in the U.S. economy.

On December 20, 2016, the PRC commenced the ten-year review of its system for regulating rates and classes for Market-Dominant products as required by the PAEA. The objective of the review is to determine if the PAEA is achieving the objectives established by Congress. As part of this review, the PRC will evaluate the annual limitation on the percentage we can increase our prices, the schedule for price increases and other aspects of how we price our products. The outcome of this review may affect our future pricing methodology.

Operating Activities

Cash provided by operating activities decreased by $246 million, or 26.9%, for the three months ended December 31, 2016, compared to the same period last year. This decrease is primarily attributable to timing differences in payroll and its related accrual, given that a biweekly payroll disbursement took place on December 30, 2016, the last business day of the period.

Exigent Surcharge

As described previously in *Operating Revenue and Volume*, we began collecting an exigent surcharge on Market-Dominant products in January 2014, and continued to do so until we recovered over $4.6 billion of incremental revenue from the surcharge. We estimated that the incremental revenue limit on the incremental exigent surcharge was reached on April 10, 2016, and we therefore reduced the prices of most Market-Dominant products on that date as required by an order of the PRC. As a result of the expiration of the surcharge, our revenue and cash flow for the three months ended December 31, 2016, was negatively affected. During the three months ended December 31, 2015, our revenue and cash flows benefited by approximately $570 million from the exigent surcharge.

Price Increases

On October 12, 2016, we filed a notice with the PRC of our intent to increase prices for certain Market-Dominant services by an average of 0.9%. The PRC subsequently approved this change, and it went into effect on January 22, 2017. We estimate this change will generate approximately $255 million in additional revenue and cash flow for the remainder of 2017, and approximately $360 million per year thereafter.

On October 19, 2016, we filed a notice with the PRC of our intent to increase prices for certain Competitive services by an average of 3.9%. The PRC subsequently approved this change, and it went into effect on January 22, 2017. We estimate this change will generate approximately $336 million in additional revenue and cash flow for the remainder of 2017, and approximately $507 million per year thereafter.

Investing Activities

We invested $442 million in the purchase of property and equipment for the three months ended December 31, 2016, an increase of $167 million compared to the same period last year. The increase was due to our need to make much-needed investments in building improvements, vehicles, equipment and other capital projects, which we have delayed in recent years.

We currently estimate that cash outlays for capital assets will amount to approximately $1.4 billion for the remainder of 2017, and an additional $7.5 billion for the periods of 2018 through 2021, as we plan to invest in a new fleet of delivery vehicles and other capital expenditures. Although our future projections include these capital cash outlays, future cash flow from operations alone may not generate the cash needed for such necessary capital expenditures.

In order to conserve cash, we reduced our capital expenditures by approximately 35% from an annual average of approximately $1.5 billion in years 2009 through 2011 to an annual average of approximately $960 million in years 2012 through 2016. However, as noted above, we have increased our planned capital expenditures in order to address our aging facilities and vehicles and to upgrade our equipment to remain competitive in the marketplace and to ensure that we will be able to continue to meet our statutory obligation to provide prompt, efficient and reliable postal services to the nation.

Our delivery fleet includes approximately 142,000 delivery vehicles that are at least 20 years old and at or near the end of their useful lives. Repair and maintenance costs for these vehicles have risen significantly in recent years. We have deferred facilities maintenance, other than for health and safety reasons, to save cash. Investments in sorting and handling equipment are needed to fully capitalize on business opportunities in the growing package delivery market, and we must also invest in letter sorting equipment that is at or near the end of its useful life.

Financing Activities

Except as described otherwise in this quarterly report, the nature and amounts of our payment obligations under our debt, capital and operating lease agreements, purchase commitments and other liabilities as of December 31, 2016, have not materially changed from those described in our Annual Report.

On September 30, 2012, we reported that we had reached the maximum borrowing amount allowed under our statutory debt ceiling, and the amount of debt we have reported each quarter has not changed since then. Our debt is borrowed from the Federal Financing Bank ("FFB"), a government-owned corporation under the general supervision of the Secretary of the Treasury, and consists of fixed and floating-rate notes and two revolving credit facilities with various maturities with an aggregate principal balance of $15.0 billion as of December 31, 2016, and September 30, 2016. September 30, 2012, was also when we reported cash balances of $2.3 billion, our lowest annual cash balances reported during the past five years. Our liquidity has slowly improved since this low point.

The two revolving credit facilities have interest rates determined by the U.S. Department of the Treasury each business day and enable us to draw up to $4.0 billion in total. As of December 31, 2016, and September 30, 2016, these facilities were fully drawn and were included in the current portion of debt. These annually-renewable facilities were renewed and extended through April 2017.

LIQUIDITY OUTLOOK

With the anticipated continued migration to electronic communication and transactional alternatives, we continue to pursue legislation to reform our business model and streamline our burdensome regulatory structure. Such changes might include the adoption of USPS-specific economic and demographic assumptions for calculating our pension liabilities, restoring all or some of the exigent surcharge by making it a part of our rate base, and giving us some additional product flexibility.

Additionally, reform is needed to establish a set of healthcare plans within the FEHB that would fully integrate with Medicare for current and future retirees. We believe such reform would make our retiree health benefits system affordable by virtually eliminating the unfunded PSRHBF liability and the $33.9 billion liability due to OPM previously noted. Although we continue to inform the Administration, Congress, the PRC and other stakeholders of the immediate and long-term financial challenges we face, we have no assurances that our requests will result in meaningful reform in the foreseeable future.

2017 and Beyond

As discussed elsewhere in this report, our PSRHBF funding requirements changed in 2017, and OPM will determine the amount of annual payments we will need to make to amortize the PSRHBF unfunded liability by June 30, 2017. Based on OPM's preliminary PSRHBF valuation we estimate that the related amortization payments for the $18.2 billion unfunded liability will be $907 million annually. We are also obligated to begin paying the normal costs of retiree health benefits attributable to the service of our employees during the most recently ended fiscal year, which OPM currently estimates is approximately $2.9 billion in 2017.

Furthermore, we also remain obligated to fund the $33.9 billion in PSRHBF prefunding payments that we defaulted on for the years 2012 through 2016. OPM may establish a payment schedule by June 30, 2017, for this liability that could include a progress payment we would owe in 2017.

As discussed elsewhere, obligations pertaining to CSRS also changed in 2017 according to the PAEA. OPM will now determine the amount of annual payments we must make to fully amortize its CSRS unfunded liabilities, and OPM estimates that this payment obligation will be approximately $1.2 billion annually, which may be required as soon as September 2017. This matter is currently under review by the Office of Legal Counsel at the U.S. Department of Justice, to confirm whether these payments should begin in 2017 or 2018.

We estimate that our cash outlays for necessary and overdue capital assets will amount to $1.4 billion for the remainder of 2017 and an additional $7.5 billion for the periods of 2018 through 2021. Although our future projections include these capital cash outlays, future cash flow from operations alone may not generate the cash needed for such necessary capital expenditures.

We anticipate that given our ongoing liquidity concerns, and without legislative action, we may not be able to make all legally-required payments in 2017. Additionally, we believe that continuing productivity improvements alone will not be sufficient to address the challenges presented by declining Market-Dominant volume and revenue, and that revenue enhancements will unlikely be able to keep pace with increased costs.

Contingency Plans

Our status as an independent establishment of the executive branch that does not receive tax dollars for our operations presents unique requirements and restrictions, but also potentially mitigates some of the financial risk that would otherwise be associated with a cash shortfall. With annual revenue of approximately $71 billion, generated almost entirely through the sale of our services, a financially-sound Postal Service continues to be vital to U.S. commerce.

In the event that circumstances leave us with insufficient cash, we would likely be required to implement contingency plans to ensure that mail deliveries continue. These measures may require us to prioritize payments to our employees and suppliers ahead of some payments to other U.S. government entities, as has been done in the past. Without structural change to our business model and legislative change, the factors discussed above will continue to negatively impact us resulting in continuing losses and liquidity challenges for the foreseeable future.

LEGISLATIVE UPDATE

We are subject to oversight by Congress, which significantly influences how we conduct our business and operations through passage of laws. Additionally, we are governed by an eleven-seat Board of Governors ("Board") which generally consists of our Postmaster General, Deputy Postmaster General and nine independent governors ("Governors"). The Governors are appointed by the President with the advice and consent of the Senate.

LEGISLATION

The 114th Congress adjourned without taking action on two major postal reform bills: the *Postal Service Reform Act of 2016* (H.R. 5714) and the *Improving Postal Operations, Service and Transparency Act of 2015* (S. 2051). Both bills included provisions designed to help us achieve financial viability. Legislative and regulatory reforms remain critical for us to meet the needs of the American public, and we will continue to work with Congress and all of our stakeholders to enact comprehensive legislation.

BOARD OF GOVERNORS NOMINATIONS

During the 114th Congress, the Senate failed to act on the President's nominations to the Board of Mickey D. Barnett, David Michael Bennett, Stephen Crawford, Jeffrey A. Rosen, James C. Miller III and David S. Shapira. Those nominations were returned to the President upon the adjournment of Congress on January 3, 2017. On December 8, 2016, the hold-over term of our last remaining independent Governor expired, and as a result the Board has no presidentially appointed Governors for the first time since we began operations as the United States Postal Service in 1971.

FAIR VALUE MEASUREMENTS

As required by authoritative accounting literature, certain fair value disclosures for the periods ended December 31, 2016, and September 30, 2016, and are contained in *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*. We did not recognize gains as a result of valuation measurements during the three months ended December 31, 2016. All recognized losses have been incorporated into our financial statements as of December 31, 2016. See *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*, *Note 9 - Fair Value Measurement.*

RELATED PARTY TRANSACTIONS

As disclosed throughout this quarterly report, we have significant transactions with other U.S. government entities, which are considered related parties for reporting purposes. For a more detailed description, see *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*, *Note 3 - Related Parties*.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with GAAP requires management to make significant judgments and estimates to develop certain amounts reflected and disclosed in the financial statements. In many cases, alternative policies or estimation techniques may be used.

We maintain a thorough process to review the application of accounting policies and to evaluate the appropriateness of the many estimates that are required to prepare the financial statements of a large organization. However, even under optimal circumstances, estimates routinely require adjustment based on changing circumstances and new or better information.

The accounting policies deemed either the most judgmental or which involve the selection or application of alternative accounting policies, and are material to the interim financial statements, are described in *Critical Accounting Estimates* contained in *Management's Discussion and Analysis of Financial Condition and Results of Operations* of the Annual Report. Management discusses the development and selection of accounting policies and estimates with the Audit and Finance Committee of the Board.

RECENT ACCOUNTING STANDARDS

See *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*, *Note 1 - Basis of Presentation*, *Recent Accounting Standards* for a description of recently announced accounting standards.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the normal course of business we are exposed to market risks from changes in commodity prices, certain foreign currency exchange rates and interest rates. Our commodity price risk consists primarily of exposure to changes in prices for diesel fuel, unleaded gasoline and aircraft fuel for transportation of the mail, and fuel for heating facilities. We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail.

We have not used derivative commodity or financial instruments to manage market risk related to commodities, foreign currency exchange or interest rate fluctuations for debt instruments. Additionally, we do not purchase or hold derivative financial instruments for speculative purposes.

We also have provisions in our debt agreements that allow us to prepay our $15.0 billion debt at any time at a price determined by the Secretary of the Treasury, based on prevailing interest rates in the Treasury Security market at the time of repayment.

See *Item 7A. Quantitative and Qualitative Disclosures about Market Risk* in the Annual Report for additional information.

ITEM 4. CONTROLS AND PROCEDURES

Management is responsible for the preparation, integrity and fair presentation of our financial statements.

DISCLOSURE CONTROLS

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in quarterly and annual reports is recorded, processed, summarized, and reported within the time frames specified by PAEA, and that this information is accumulated and communicated to our management, including the Postmaster General and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation under the supervision and with the participation of management, including the Postmaster General and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls and procedures as of December 31, 2016. Based upon and as of the date of the evaluation, the Postmaster General and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

INTERNAL CONTROLS

During the three months ended December 31, 2016, one change occurred that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. As further described in *Item 1A. Risk Factors*, on December 8, 2016, the hold-over term of our last remaining independent Governor expired, and as a result, the Board has no presidentially appointed Governors for the first time since we began operations in 1971. Therefore, the oversight function for our system of internal control has changed.

Other than the item discussed above, we have made no changes in our internal control over financial reporting during the three months ended December 31, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For a discussion of legal proceedings affecting us, please refer to *Item 1. Financial Statements*, *Notes to Unaudited Financial Statements*, *Note 2 - Liquidity*, *Liquidity Concerns*, *Expiration of Exigent Surcharge* and *Note 5 - Commitments and Contingencies*, as well as our Annual Report.

ITEM 1A. RISK FACTORS

Although the Postal Reorganization Act established our eleven-seat Board with nine seats for independent Governors, the number of Governors in office is now zero, and our continuing authority to take certain important actions is untested.
On December 8, 2016, the hold-over term of our last remaining independent Governor expired, and as a result the Board has no presidentially appointed Governors for the first time since we began operations as the United States Postal Service in 1971. During the 114th Congress, the Senate failed to act on any of the President's six nominations to the Board, and those nominations were returned to the President upon the adjournment of Congress on January 3, 2017.

The Temporary Emergency Committee of the Board, which is exercising those powers of the Board necessary for continuity of operations, now consists only of our Postmaster General and Deputy Postmaster General. As described in our Annual Report, certain powers are vested in the Governors alone. These powers include setting our prices, approving new services and appointing (and, if necessary, removing) our Postmaster General and Deputy Postmaster General. Because no Governors are currently in office, it is uncertain how the important powers reserved to the Governors can be exercised.

Although the Postal Service's Competitive service revenues have increased, this increase is largely due to significant volume growth from three major customers, all of whom are building the capability which would enable them to divert volume away from the Postal Service.
The growth in our Competitive service revenues over the past five years is largely attributable to three major customers. Each of those three major customers is building the capability which would enable them to divert volume away from the Postal Service over time. If those customers divert significant volume away from the Postal Service, the growth in our Competitive service revenues may not continue.

No other material changes have transpired in our risk factors from those disclosed in *Item 1A. Risk Factors* of our Annual Report.

ITEM 6. EXHIBITS

Exhibit Number	Description
31.1	Certification of Principal Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the *Securities and Exchange Act of 1934*, as Adopted Pursuant to Section 302 of the *Sarbanes-Oxley Act of 2002*.
31.2	Certification of Principal Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) under the *Securities and Exchange Act of 1934*, as Adopted Pursuant to Section 302 of the *Sarbanes-Oxley Act of 2002*.
32.1	Certification of Principal Executive Officer Pursuant to *18 U.S.C. Section 1350*, as Adopted Pursuant to Section 906 of the *Sarbanes-Oxley Act of 2002*.
32.2	Certification of Principal Financial Officer Pursuant to *18 U.S.C. Section 1350*, as Adopted Pursuant to Section 906 of the *Sarbanes-Oxley Act of 2002*.

Signatures

Pursuant to the requirements of the *Postal Accountability and Enhancement Act of 2006*, the United States Postal Service has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

United States Postal Service

/s/Megan J. Brennan
Megan J. Brennan
Postmaster General and Chief Executive Officer

Date: February 8, 2017

/s/Joseph Corbett
Joseph Corbett
Chief Financial Officer and Executive Vice President

Date: February 8, 2017

Exhibit 31.1

CERTIFICATION PURSUANT TO
RULES 13a-14(a) AND 15d-14(a) UNDER THE SECURITIES AND EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

I, Megan J. Brennan, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the United States Postal Service ("Postal Service");

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Postal Service as of, and for, the periods presented in this report;

4. The Postal Service's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Postal Service and have:

    a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Postal Service, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

    c. Evaluated the effectiveness of the Postal Service's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d. Disclosed in this report any change in the Postal Service's internal control over financial reporting that occurred during the Postal Service's most recent fiscal quarter (the Postal Service's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the Postal Service's internal control over financial reporting; and

5. The Postal Service's other certifying officer and I have disclosed based on our most recent evaluation of internal control over financial reporting, to the Postal Service's independent registered accounting firm and the Audit and Finance Committee of the Postal Service's Board of Governors (or persons performing the equivalent functions):

    a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Postal Service's ability to record, process, summarize and report financial information; and

    b. Any fraud, whether or not material, that involves management or other employees who have significant role in the Postal Service's internal control over financial reporting.

Date: February 8, 2017

/s/Megan J. Brennan

Megan J. Brennan

Postmaster General and Chief Executive Officer

Exhibit 31.2

CERTIFICATION PURSUANT TO
RULES 13a-14(a) AND 15d-14(a) UNDER THE SECURITIES AND EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

I, Joseph Corbett, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the United States Postal Service ("Postal Service");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Postal Service as of, and for, the periods presented in this report;
4. The Postal Service's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Postal Service and have:
    a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Postal Service, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c. Evaluated the effectiveness of the Postal Service's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    d. Disclosed in this report any change in the Postal Service's internal control over financial reporting that occurred during the Postal Service's most recent fiscal quarter (the Postal Service's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the Postal Service's internal control over financial reporting; and
5. The Postal Service's other certifying officer and I have disclosed based on our most recent evaluation of internal control over financial reporting, to the Postal Service's independent registered accounting firm and the Audit and Finance Committee of the Postal Service's Board of Governors (or persons performing the equivalent functions):
    a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Postal Service's ability to record, process, summarize and report financial information; and
    b. Any fraud, whether or not material, that involves management or other employees who have significant role in the Postal Service's internal control over financial reporting.

Date: February 8, 2017

/s/Joseph Corbett

Joseph Corbett

Chief Financial Officer and Executive Vice President

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002.

In connection with the Quarterly Report of the United States Postal Service ("Postal Service") on Form 10-Q for the period ended December 31, 2016, (the "Report"), I, Megan J. Brennan, certify, pursuant to *18 U.S.C. Section 1350*, as adopted pursuant to Section 906 of the *Sarbanes-Oxley Act of 2002* that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the *Securities Exchange Act of 1934*; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Postal Service.

Dated: February 8, 2017

/s/Megan J. Brennan

Megan J. Brennan

Postmaster General and Chief Executive Officer

Exhibit 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002.

In connection with the Quarterly Report of the United States Postal Service ("Postal Service") on Form 10-Q for the period ended December 31, 2016, (the "Report"), I, Joseph Corbett, certify, pursuant to *18 U.S.C. Section 1350*, as adopted pursuant to Section 906 of the *Sarbanes-Oxley Act of 2002* that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the *Securities Exchange Act of 1934*; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Postal Service.

Dated: February 8, 2017

/s/Joseph Corbett
Joseph Corbett
Chief Financial Officer and Executive Vice President